

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Release Number: **200411011**

Release Date: 03/12/2004

Index Number: 1.1362.02-03

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:B01 – PLR-135714-03

Date:

Dec 8 2003

Legend

Company =

State =

Year 1 =

Year 2 =

Year 3 =

Date 1 =

Date 2 =

\$A =

\$B =

\$C =

\$D =

W =

X =

Y =

Z =

Dear :

This responds to a letter dated June 5, 2003, together with subsequent correspondence, submitted on behalf of Company, requesting a ruling that the income it received with respect to its copyrights, trademarks and related intellectual property derived from its literary and film rights does not constitute passive investment income within the meaning of section 1362(d)(3)(C)(i) of the Internal Revenue Code because such income constitutes royalties derived in the ordinary course of a trade or business of licensing or franchising property within the meaning of section 1.1362-2(c)(5)(ii)(A)(2).

PLR-135714-03

Facts

Company was incorporated in State in Year 1, and was a C corporation until it filed an election to be treated as an S corporation, effective Date 2. Company's principal business is the production of feature-length motion pictures, and the licensing of related television, home video and sound reproductions and other allied rights, including the rights to produce related merchandise.

In addition, in Year 1, Company acquired the film, and allied rights, to X. Over the next several years, Company spent approximately \$D producing Y, a film based on X. In Year 2, Company licensed some of its rights to X for the purpose of producing Z. Company was involved in the production and development of Z: consulting on the scripts, suggesting musicians, discussing casting, and viewing some of the film footage during the editing process. On the marketing side, Company organized promotional showings for writers, critics and others in the film industry.

In Year 3, Company licensed some of its rights to X for the purpose of producing W. Company is involved in the production and development of W: consulting on scripts and music, and has rights to approve authors, scripts, music, directors, sets and costume designers, principal cast members, and promotional activities.

Company has also entered into numerous merchandising agreements with others companies to allow them to produce products relating to X. Company spends considerable amount of time negotiating, monitoring and enforcing compliance with such agreements. All merchandise is submitted to Company for its approval of trademarks and Company employees spend significant time inventorying, photographing and inspecting such merchandise.

For its taxable year ending Date 1, Company received approximately \$A in revenues with respect to its licensing of rights relating to films it produced, \$B in revenues with respect to its licensing of rights relating to its interest in X, and \$C in investment income. Company has accumulated earnings and profits.

Law and Analysis

Except as provided in section 1362(g), section 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of section 1362, to be a subchapter S corporation.

PLR-135714-03

Section 1362(d)(3)(A)(i) provides that an election under section 1362(a) terminates whenever the corporation (I) has accumulated earnings and profits at the close of each of three consecutive years, and (II) has gross receipts for each of such tax years more than 25 percent of which are passive investment income.

Except as otherwise provided in section 1362(d)(3)(C), section 1362(d)(3)(C)(i) provides that the term “passive investment income” means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities.

Section 1.1362-2(c)(5)(ii)(A)(1) of the Income Tax Regulations provides that “royalties” means all royalties, including mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, good will, trademarks, tradebrands, franchises, and other like property.

Section 1.1362-2(c)(5)(ii)(A)(2) provides that “royalties” does not include royalties derived in the ordinary course of a trade or business of franchising or licensing property. Royalties received by a corporation are derived in the ordinary course of a trade or business of franchising or licensing property only if, based on all the facts and circumstances, the corporation (1) created the property; or (2) performed significant services or incurred substantial costs with respect to the development or marketing of the property.

Conclusion

After applying the law to the facts submitted and representations made, we conclude that the income Company receives with respect to licensing of literary, film and allied rights relating to films it produced and its interest in X, is not passive investment income under section 1362(d)(3)(C)(i).

Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, no opinion is expressed regarding whether Company otherwise satisfies the S corporation eligibility requirements under section 1361. In addition, no opinion is expressed as to whether the royalties also qualify as “produced film rents” within the meaning of section 1362.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

PLR-135714-03

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the first and second attorneys listed.

Sincerely,

/s/ David R. Haglund

David Haglund
Senior Technician Reviewer, Branch 1
Office of the Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes

Cc: